

# LEGAL UPDATE

## CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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### ESTATE PLANNING

#### REVISED FREQUENTLY ASKED QUESTIONS—PART I

Over the years Roy and I have repeatedly received the same estate planning questions from clients. So, we have revised our FAQ section to better address your questions. Enjoy.

##### Frequently-Asked Questions about Estate Planning

###### Managing your documents

1. Where should I keep the original signed documents?

Keep the originals in a safe place – our recommendation is a safe-deposit box that is in joint names with at least one other person. We provide you copies of your estate plan (one of which will be in an indexed and tabbed binder) and we retain a copy for our permanent files. Do not write on the originals because that could invalidate them. We suggest you keep copies with the rest of your important documents. Write on the copies where you have placed the originals so that people can find the originals when they are needed.

2. To whom should I give copies of my estate plan?

These are personal, private documents that are likely to be changed at some time in the future. We generally favor limiting distribution of wills and trusts. If you anticipate possible death or

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### TAX

#### REASONABLE COMPENSATION – PART III

In the first two parts of this article, we discussed *reasonable compensation* under Section 162 of the Internal Revenue Code in the context of closely-held C corporations. It is sometimes to the advantage of employee-shareholders of closely-held C corporations to maximize salary payments because compensation is deductible and dividends are not. Factoring in the marginal tax rates for the corporation, for the individual employee-shareholder, and for dividends received by the employee-shareholder, the company's accountant can calculate a salary which results in the lowest possible over-all tax liability. Nevertheless, the Internal Revenue Service (IRS) might challenge the compensation so fixed as unreasonable. We discussed the factors considered by the IRS and the courts in evaluating such cases and a recent case which operationalizes these factors.

In the context of S corporations, reasonable compensation takes a different complexion because S corporations are flow-through entities with just one level of taxation. However, that portion of employee-shareholder compensation deemed to be salary is saddled with payroll taxes of 6.2% for Social Security (up to a certain annual limit) and 1.45% for Medicare (with no annual limit). The employer corporation pays another 6.2% and 1.45%, so the burden on the employee-shareholder is really 15.3 % of salary payments. It is thus to the advantage of employee-shareholders to minimize salary payments and avoid payroll taxes. Any salary payment above the upper limit for Social Security tax will not result in an increased retirement annuity (assuming Social Security is even solvent at the time) but will result in an extra 2.9% of Medicare tax. Moreover, if the employee-shareholder is a good investor, he or she might end up with a larger over-all retirement income by taking less in salary, thus receiving a lower Social Security annuity, but investing the payroll tax savings wisely.

Needless to say the Service does not look

kindly on such manipulation. In evaluating reasonable compensation in the S corporation context, the IRS and the courts will consider the same factors as in the C corporation context, except they will be looking for compensation which is abnormally *low* rather than abnormally *high*. A good place to start is the upper salary limit for Social Security tax, \$106,800 in 2009. A CEO of a profitable company who makes much less than this amount is probably earning an unreasonably low salary. Nonetheless, there might be valid reasons for earning less than that amount in a particular year. In order to defend the validity of such a salary, taxpayer should take a careful look at the factors discussed in Part I of this article.

Limited liability company (LLC) employee-members face a different set of problems because LLC's are taxed as partnerships. However, for purposes of self-employment tax (the equivalent of payroll taxes for S corporations), employee-members need to be classified as the equivalent of general or limited partners. The IRS has issued proposed regulation 26 C.F.R. §1.1402(a)-2, which, although not technically in effect, is the only guidance we have for LLC's. The proposed regulation is itself quite complex, and for reasons of space we cannot set forth all its provisions. Nonetheless, the comprehensive example at the end of the regulation provides a fairly clear explanation of how the rule works.

A, B and C form LLC, a limited liability company under the laws of State, to engage in a business which is not a service partnership under the regulations. LLC is classified as a partnership for federal tax purposes and allocates all items of income, deduction and credit of LLC to A, B and C in proportion to their ownership of LLC. A and C each contribute \$1,000 for one LLC unit. B contributes \$2,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC's tax items, including profits. A does not perform services for LLC. B receives a guaranteed payment of \$60,000 per year for 600 hours of services rendered to LLC. C receives a guaranteed payment of \$100,000

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**EMPLOYMENT LAW****INTERNS – PAID OR UNPAID?**

Businesses looking for short term staffing assistance frequently look to interns to fill the gap between temporary employees and regular employees while students and recent graduates look to internships to bolster resumes lacking in experience. Regardless of the reason for this marriage of employer and intern, the fundamental question of compensation for the intern must be addressed *prior* to the start of the relationship.

On the federal level, compensation issues generally fall to the Fair Labor Standards Act (“FLSA”). While many state wage payment laws also affect internship compensation (and wage payment requirements generally), this article will only address the FLSA component. The United States Department of Labor, the federal agency charged with enforcing the FLSA, has issued guidance to help employers determine whether an internship should be paid or unpaid when the intern works for a private sector, for-profit business. The intern must be paid unless all six of the following factors are met:

- The training provided to the intern is similar to that which would be given in a vocational school or in an academic setting.
- The training must be for the benefit of the intern (and not the employer).
- The intern may not displace regular employees; rather, the intern must work under the supervision of a regular employee.
- The employer may not derive a benefit or advantage from the activities of the intern and may even have its operations impeded by the intern.
- The intern is not automatically entitled to a job at the conclusion of the internship.
- The intern understands prior to the start of the internship that he/she is not entitled to compensation.

The FLSA does not allow an intern otherwise entitled to compensation to waive his/her right to payment. In fact, no employee is permitted to waive a right to compensation, including overtime compensation. This prohibition on waiving compensation otherwise required to be paid by the FLSA applied in *all* circumstances, even if it is the employee/intern who suggests the waiver. Thus, agreement from the intern to waive pay will not alter the compensation requirement. As the Department of Labor has stated that it is stepping up review and enforcement

actions in wage payment matters, employers are urged to review compensation policies, including those for interns.

**PHILIP SCHWARTZ**

**TAX**

*Continued from page 1*

per year for 1000 hours of services rendered to LLC. C is also the LLC manager and under the law of State has authority to contract on behalf of LLC.

A is treated as a *limited partner* because she is not liable personally for debts or claims against LLC, does not have the authority to contract for LLC and does not participate in the business for more than 500 hours per year. Therefore, A’s distributive share is excluded from A’s net earnings from self-employment.

B’s guaranteed payment of \$60,000 is included in her earnings from self-employment. She is not treated as a limited partner because, although she is not liable for debts or claims against LLC and does not have authority to contract, B does participate in the business for more than 500 hours per year. B is not treated as a limited partner because B does not hold more than one class of interest in LLC. However, B is treated as a *limited partner* under another provision of the regulation because B is not treated as a limited partner solely because B worked more than 500 hours and because A is a limited partner who owns a substantial interest with rights and obligations identical to B’s. Thus, B’s distributive share is deemed to be a return on investment, not remuneration for services, and, therefore, not subject to self-employment tax.

C’s guaranteed payment of \$100,000 is obviously subject to self-employment tax. Moreover, C’s distributive share is also subject to self-employment tax because C is not a limited partner since she has the authority to bind the LLC and works more than 500 hours. Moreover, she is not treated as a limited partner because she does not hold more than one class of interest. Therefore, C’s guaranteed payment and distributive share both are included in C’s net earnings from self-employment.

Clearly, the rules applicable to LLC’s are more technical than the rules applicable to corporations, C or S. But, in general, partnership taxation is dry and tedious so there are no surprises there.

**NÉSTOR CRUZ**

**EVIDENCE****VIRGINIA COURT ADDRESSES WAIVER OF PRIVILEGE**

Generally speaking communications between a client and his or her counsel are deemed confidential—that is, a *privileged* matter that presumptively will not be admitted as evidence at trial. The Supreme Court of Virginia recently clarified the Commonwealth’s law regarding when a party has waived this attorney-client privilege.

In *Walton v. Mid-Atlantic Spine Specialists P.C.*, No. 091009 (June 10, 2010), the key issue was whether a physician’s letter to counsel could be admitted in a medical malpractice case. The physician had conceded in his letter—sent during an earlier workers compensation matter—that he may have mistakenly read and based an assessment on the wrong X-ray. In subsequent medical malpractice litigation, the physician’s medical group hired a commercial copier to copy records in response to a discovery request. Unbeknownst to the party or counsel, the smoking-gun letter was included. Exacerbating the situation plaintiff’s counsel had the letter for almost three years before defense counsel realized the problem and moved to exclude the document as privileged. The trial court ruled the letter was privileged, that the privilege was not waived; therefore, the document was excluded.

On review the Supreme Court overruled the circuit court, determining that the disclosure of the letter was inadvertent and that the trial judge should have applied a multi-factor analysis articulated by other courts. With a starting point that the disclosure was inadvertent, not involuntary, the Court explained that analysis of waiver should include the following:

- The reasonableness of precautions to prevent inadvertent disclosures;
- The time taken to rectify the error;
- The scope of the discovery;
- The extent of the disclosure; and,
- Whether the party asserting privilege has used its unavailability for misleading or otherwise improper or overreaching purposes in the litigation, making it unfair to allow the party to invoke confidentiality under the circumstances.

The Court explained that no single factor is dispositive.

Applying the articulated standards the Supreme Court concluded that the physicians’ group failed to take reasonable measures to protect confidentiality of the letter. Judgment for the physicians was reversed and the matter remanded.

**LAWRENCE CARR**

**ESTATE PLANNING***Continued from page 1*

incapacity in the foreseeable future, the successor trustee should have a copy and be familiar with what will be expected of him or her.

Using the living trust to avoid court proceeding on death or incapacity

3. Should I re-title my assets into my living trust now?

The reason to fund your living trust now is to make it easy to administer your property if you die or become disabled. It would make planning much easier if we knew when we were likely to die or become disabled. Since we do not, the best practice is to hold title to assets in your living trust.

Funding the living trust can be done at any time. To the extent that you do not get this done during your lifetime, your will “pours over” the probate estate into the trust at your death. The first things to transfer are specific items that you definitely do not want tied up in probate, such as closely-held company stock and out-of-state real estate.

Funding the living trust does entail a certain amount of paperwork and expense, particularly with real estate, which requires recordation of a deed.

Failing to fund the living trust does not invalidate the estate tax savings strategies we typically incorporate into plans of high net-worth clients. It merely increases the cost, time and administrative complexity of implementing them.

All things considered, particularly the unpredictability of life, the only responsible answer to this question is “yes.”

4. How do I transfer title to specific assets to my living trust?

The process is different depending on the specific assets involved. Real estate, for example, requires a deed to be prepared by a lawyer or title company. Brokerage accounts only require instructions to your broker. We have specific instructions for re-titling various types of assets, and you can always call us if questions come up.

5. Will deeding my house to my living trust breach my mortgage? Complicate refinancing? Increase my local real estate tax rate? Cause me to lose the federal income tax exclusion of gain on sale of a principal residence?

Most home lenders and real property

tax offices are familiar with living trusts, and the practice is becoming more commonplace. For federal income tax purposes and for most local real estate tax purposes, the Grantor is treated as the owner and the trust is disregarded, so there are generally no tax consequences to the transfer. Virtually every single-family home mortgage contains a due-on-sale clause; however, Federal law prohibits lenders from enforcing a due-on-sale clause with respect to a transfer into a living trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property.

Generally, to refinance, lenders want you to deed the house back to the individual borrower, and then back into the trust after the refinance is completed, although recently we have seen some lenders allow refinancing of properties held in living trusts. We expect that trend to continue.

6. Does my living trust protect against creditors?

A living trust does not protect assets from creditors while the grantor is living. Married couples who transfer assets held as “tenants by the entireties” (which assures that property owned by one spouse cannot be attached by creditors of the other spouse) to the living trust are giving up the creditor protection associated with that form of joint title. If creditor protection is a concern, however, we recommend integrating other more reliable techniques into your estate plan, such as irrevocable trusts and family limited partnerships.

Following the death of the grantor, trust assets are generally protected from creditors of the trust’s successor beneficiaries, depending on the terms of the trust.

7. Does my living trust have to file a tax return?

A self-trusteed revocable trust is a “disregarded entity” during the lifetime of the grantor. The assets are treated for tax purposes as if they are owned by the grantor. Any income earned by trust assets must be reported on the grantor’s individual tax return. The trust therefore uses the grantor’s social security number as its tax identification number. After the grantor’s death, the trust becomes a separate taxable entity and files its own fiduciary return.

8. How do I refer to my living trust?

The trust has a shorthand name in it. For example, the “Roy R. Morris Revocable Living Trust, dated January 1, 2010.”

9. If I have put my assets in the trust, do I then need to sign everything as trustee?

Yes, this is the best practice, because you are wearing three hats—grantor, trustee and beneficiary—and it’s best to clearly disclose the capacity in which you are acting.

10. How does my successor trustee determine if I am incapacitated?

The trust document establishes a standard which does not involve a court declaration of incapacity. For example: “If at any time the Grantor, in the judgment of the successor Trustee, shall be under any legal disability or shall be unable to manage properly her affairs by reason of illness or mental or physical disability, the successor Trustee may...” The successor trustee makes the determination in his own judgment, usually with the advice of your treating physician.

11. Who should serve as successor trustee? A relative or a professional?

Frequently, the first successor trustee is your spouse or life partner. If assets are being held for minor children, you need a trustee who is sensible and trustworthy, who will prudently administer the trust estate for the benefit of your children. If your children are already independent mature adults, you may name them as co-Trustees. You may also designate a professional trustee, to assure integrity and accountability and to take some of the management burden off an individual trustee. We can recommend professional trustees with whom we have worked. Sometimes a combination of professional and individual co-trustees is a good compromise.

12. Should the children’s guardian also serve as trustee?

A guardian takes care of the physical and emotional needs of a child, while a trustee manages the trust assets and makes distributions for the benefit of the beneficiary’s health, education, maintenance and support. Often these functions can be performed by the same individual. They are entirely different functions, however, requiring different qualifications.

[Part II will follow in our next newsletter]  
**ROY MORRIS & JUSTIN BANFORD**

## CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial litigation; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

## STAFF NOTES

*Beach 'n books.* It's Summer, so what reading recommendations can we pass along?

- Larry Carr: *Where Men Win Glory: the Odyssey of Pat Tillman* by Jon Krakauer; *Pirate Latitudes* by Michael Chrichton; *The Book Thief* by Markus Zusak
- Steve Graeff: *Mudbound* by Hillary Jordan; *The Last Child* by John Hart; *The Shadow of the Wind* by Carlos Ruiz Zaton
- Phil Schwartz: *The Blind Side* by Michael Lewis; *John Adams* by David McCullough
- Justin Banford: *The Big Short* by Michael Lewis; *Winning 42: Strategy & Lore of the National Game of Texas* by Dennis Roberson
- Nestor Cruz: *Iron Kingdom: The Rise and Downfall of Prussia, 1600-1947* by Christopher M. Clark; *Medieval Germany, 500-1300: A Political Interpretation* by Benjamin Arnold; *The Making of Europe: Conquest, Colonization, and Cultural Change, 950-1350* by Robert Bartlett

\* \* \*

**CMG trivia.** In the spirit of World Cup play: which CMG attorney played the *beautiful game* with some degree of success in high school?

*Trivia answer:* Both Dana Theriot and Justin Banford played soccer in high school. Dana was a stopper for the Oakton Cougars. Justin played midfield for the Great Bridge Wildcats in Chesapeake.

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